No. 12418

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

California State Board of Equalization,

Appellant,

vs.

George T. Goggin, Receiver in Bankruptcy of the Estate of Exeter Refining Company,

Appellee.

APPELLEE'S REPLY BRIEF.

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TOPICAL INDEX

TABLE OF AUTHORITIES CITED

Cases

Statutes

Textbooks

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Statement of the Case.

This appeal is from an order of the Court refusing to allow the California State Board of Equalization two penalties included in its claim for taxes.

The first of these two penalties is for the sum of $293.48, and is claimed for failure to file sales tax returns after bankruptcy proceedings were commenced, but covering a period which preceded bankruptcy. [See App. Op. Br. p. 5, last paragraph, and Certificate on Review, Tr. p. 33.]

The second of the disallowed penalties is claimed by appellant for failure of the receiver to pay the taxes on or before March 7, 1948, the taxes in question becoming due before bankruptcy, but the date of March 7th being

after bankruptcy, and before it was determined what kind of a plan of arrangement or composition would be approved, if at all, or whether an adjudication would be entered. [See App. Op. Br. p. 6 and Certificate on Review, Tr. p. 34.]

Although the appellant filed its claim herein in the usual form, claiming these penalties together with taxes, as a claim against the estate as distinguished from an expense of administration, it has since conceded that the penalties are allowable, if at all, as expenses of administration. (See App. Op. Br. p. 7.)

ARGUMENT.

The Rights of Creditors Are Fixed as of the Date of the Filing of the Petition in Bankruptcy.

Our courts have repeatedly held that the rights of creditors are fixed as of the date of the filing of the petition in bankruptcy. A few of such decisions are:

United States v. Marxen, 307 U. S. 200;

In re Groenleer-Vance Furniture Co., 23 Fed. Supp. 713 at 715;

In re Miller, 105 F. 2d 926;

Colorado Nat'l Bank v. Newton, 80 F. 2d 696;

In re Gotham Can Co., 45 F. 2d 849, 48 F. 2d 540.

Penalties Not Allowable in Bankruptcy.

Section 57-j of the Bankruptcy Act provides:

> "Debts owing to the United States or any State or subdivision thereof as a penalty or forfeiture shall not be allowed, except for the amount of the pecuniary loss sustained by the act, transaction, or proceeding out of which the penalty or forfeiture arose, with

reasonable and actual costs occasioned thereby and such interest as may have accrued thereon according to law."

The above provision of the Bankruptcy Act is written into the provisions of Chapter XI of the Bankruptcy Act by reference. Section 302 of Chapter XI of the Bankruptcy Act provides:

> "The provisions of chapters I to VII, inclusive, of this Act shall, insofar as they are not inconsistent with or in conflict with the provisions of this chapter, apply in proceedings under this chapter. For the purposes of such application, provisions relating to 'bankrupts' shall be deemed to relate also to 'debtors,' and 'bankruptcy proceedings' or 'proceedings in bankruptcy' shall be deemed to include proceedings under this chapter. For the purposes of such application the date of the filing of the petition in bankruptcy shall be taken to be the date of the filing of an original petition under section 322 of this Act, and the date of adjudication shall be taken to be the date of the filing of the petition under section 321 or 322 of this Act except where an adjudication had previously been entered."

But appellant contends that notwithstanding the above quoted provisions of the Bankruptcy Act, Section 307 of Chapter XI of the Act is broad enough to permit and authorize the allowance of the tax penalties herein claimed.

Section 307 provides:

> "Unless inconsistent with the context and for the purpose of an arrangement providing for an extension of time for payment of debts in full *and applicable exclusively to the debts to be extended*—

"(a) 'creditors' shall include the holders of all unsecured debts, demands, or claims of whatever character against a debtor, whether or not provable as debts under section 63 of this Act and whether liquidated or unliquidated, fixed or contingent; and

"(2) 'debts' or 'claims' shall include all unsecured debts, demands, or claims of whatever character against a debtor, whether or not provable as debts under section 63 of this Act and whether liquidated or unliquidated, fixed or contingent." (Emphasis ours.)

There are several sound answers to appellant's contention, but the emphasized portion of the quotation above prevents tax claims and tax penalties from falling within the purview of this section. Tax claims, as we shall presently see, cannot be extended in Chapter XI proceedings unless the taxing agency consents thereto—and they never consent. In this connection, it is interesting to note that appellant is not consenting to its tax claim being extended, but on the contrary, is insisting upon payment in full, including penalties, and because the receiver did not pay in full before March 7, 1948, which was at a time before approval of the plan, and before the receiver could have legally paid any claim in the bankruptcy proceedings, this appellant is seeking to penalize the estate further by demanding another penalty in the sum of $350.30.

Therefore, appellant's debt hardly falls in the class of "debts to be extended."

Collier on Bankruptcy, 14th Edition, Vol. 8, page 68, in commenting upon Section 307 of Chapter XI, says:

"Section 307 defines 'creditors' and 'debts' or 'claims.' 'Creditor' is also defined in §1(11), while 'debt' is also defined in §1(14). The definitions in

§307 apply only 'for the purposes of an arrangement providing for an extension of time for payment of debts in full' and are 'applicable exclusively to the debts to be extended.' An arrangement may be by way of settlement, satisfaction or extension. Where an arrangement is by way of settlement or satisfaction, the definitions in §1(11), (14) apply. Where the arrangement is by way of an extension of time for payment of debts in full, the definitions in §307 apply, *but only to the debts to be extended.* An arrangement may provide for a division of creditors into classes and for dealing with the classes in different ways or upon different terms, or for dealing with one or more of the classes but not with all of them. An arrangement may therefore provide for an extension of time for payment in full of debts in one class, and provide for a settlement or satisfaction of debts in another class. As to debts in the former class, the definitions in §307 apply; as to debts in the latter class, the definitions in §1(11), (14) apply. But even in cases of an extension, the definitions in §307 do not apply for all purposes, but only for the purposes of the arrangement. In extension cases, those definitions would therefore be applicable to determine what debts may be dealt with in the arrangement, and to determine in general the meaning of 'creditors,' 'debts' and 'claims' whenever those words are used in connection with the arrangement itself as distinguished from other matters in the proceeding. In connection with those other matters, the definitions in §307 would not apply. Thus, the nomination of a trustee by creditors under §338 is not for the purposes of the arrangement, but on the contrary is for the purposes of the administration of the estate in bankruptcy in the event an order is entered in the Chapter XI proceeding directing bankruptcy. Hence, in determining the meaning of cred-

itors as used in §338, the definition in §1(11) rather than the definition in §307(1) would apply, even though the arrangement is by way of extension. Moreover, if the Chapter XI proceeding does not culminate in confirmation of an arrangement, but an order is entered directing that bankruptcy be proceeded with, §307 has no effect in the subsequent bankruptcy administration of the case, but only such claims as are provable under §63 can be allowed." (Emphasis ours.)

It is, and has been, our contention, from the beginning, that Section 307 above referred to has no application whatsoever to claims or debts based upon taxes or tax penalties, and in no way modifies Section 57-j and we believe that the Referee erred in allowing the penalty of $47.54 referred to on page 5 of appellant's opening brief, but the amount thereof was too small to warrant the expense of a review.

Further, in support of the trustee's contention that Section 307 above referred to does not apply to tax claims or penalties is subdivision 1 of Section 306 of Chapter XI, which provides:

> " 'Arrangement' shall mean any plan of a debtor for the settlement, satisfaction, or extension of the time of payment of *his unsecured debts,* upon any terms;" (Emphasis ours.)

So it is observed that an arrangement such as referred to in Section 307 is defined in the preceding Section 306 as having reference only to unsecured debts or, in other words, general unsecured creditors.

And again, subdivision 2 of Section 337 of Chapter XI provides:

> "fix a time within which the debtor shall deposit, in such place as shall be designated by and subject to the order of the court, the consideration, if any, to be distributed to the creditors, *the money necessary to pay all debts which have priority,* unless such priority creditors shall have waived their claims or such deposit, or consented in writing to any provision of the arrangement for otherwise dealing with such claims, and the money necessary to pay the costs and expenses of the proceedings and the actual and necessary expenses incurred in connection with the proceedings and the arrangement by the committee of creditors and the attorneys or agents of such committee, in such amount as the court may allow; and" (Emphasis ours.)

Therefore, we see that priority (tax) claimants are paid in full upon the approval of the plan unless they expressly waived their claim and do not fall within the classification of creditors whose debts are extended.

See also Section 352 of Chapter XI, which defines the rights, duties and liabilities of creditors.

And also Sections 356 and 361 of Chapter XI and also subdivision 2 of Section 367 and 371 of Chapter XI, all of which distinguishes between prior and unsecured debts and claims.

Plan of Arrangement.

Although the modified plan of arrangement, which was confirmed by the Court, is not included in the transcript, the nature of same is set forth by the Referee in his certificate on review. [See Tr. p. 32.]

In this case, the basic plan is a composition as distinguished from a plan of arrangement providing for an extension of time for the payment of debts in full. The plan here proposes a composition in that the debtor will pay its general unsecured creditors fifty per cent of its unsecured debts in full settlement thereof. However, the plan further provides that if any such creditor so elects, in writing, prior to the confirmation of the plan, the debtor will pay the debt owing to such creditor in full in certain installments. Therefore, essentially, we have two plans (or alternatives) in one, an extension and a composition.

Therefore, if appellant had been a creditor coming within the provisions of Section 307, and affected by the plan, still it did not elect, *in writing,* to an extension of the payment of its debts, and its claim would fall under the composition part of the plan whereby it would receive only fifty per cent of its entire claim, and still would not come within the purview of Section 307 for said section refers only to debts to be extended, and not to compositions.

The position which appellant attempts to take is too absurd to warrant further argument. It is a creditor with the right of priority under Section 64 of the Bankruptcy Act, and under subdivision 2 of Section 337 is entitled to be paid upon the approval of the plan but not before.

It is here contending for its right of priority, not only as to the tax, but as to penalties and interest as well.

When it is confronted with the provisions of Sections 57-j and 302 of the Bankruptcy Act, and the case of *New York v. Saper,* 336 U. S. 328, it seeks refuge under the provisions of Section 307, while still insisting upon priority of payment in full, and refuses to consent to its debt being extended. Section 307 may be a refuge for some claimants, but it is quite apparent that Congress never intended it as an aid to a tax agency to collect a penalty which Congress had elsewhere in the Act prohibited.

Receiver Was Under No Duty to File a Tax Return Covering a Period Before Bankruptcy.

While it is true that a receiver in bankruptcy must file tax returns covering his own period of operation, there is no duty imposed upon such receiver by the Bankruptcy Act or otherwise requiring such receiver to file tax returns covering a period of time before the filing of the bankruptcy petition. If counsel for appellant has any law in support of his point, we respectfully invite him to cite it.

28 U. S. C. A., Sections 959b and 960, cited by appellant, has relation only to the operation by the receiver, and he is not required to answer for the default of the operator who preceded him before bankruptcy.

The cases cited by appellant (Op. Br. p. 14) are not in point. The factual situation in those cases is entirely different. These cases, with the exception of the *Hisey* and *Boteler v. Ingels* cases, are cases where the penalty became due and liens attached before bankruptcy and are, therefore, not in point here. The *Hisey* case, as we read it, is not a bankruptcy case and, therefore, Section 57-j of the Bankruptcy Act does not apply.

The writer of this brief is thoroughly familiar with the case of *Boteler v. Ingels,* 308 U. S. 57, 60 S. Ct. 29, inasmuch as he was the Referee in Bankruptcy who relied upon the language used by the Seventh Circuit Court in the case of *In re Messenger's Merchants Lunch Room,* 85 F. 2d 1002 at 1005, and was reversed. The facts in *Boteler v. Ingels* are entirely different from the case now before the Court. In the *Boteler v. Ingels* case, the penalties were protected by a statutory lien on the vehicles from the date due, and while the license fee became due and payable before bankruptcy, yet the delinquency date arrived after bankruptcy and while the vehicles were being used for purposes of liquidation of the business of the bankrupt's estate by the trustee in bankruptcy after adjudication.

Neither are the cases cited by appellant on page 16 of its opening brief in point or helpful in arriving at the correct answer here. We have already pointed out that appellant's claim, whether contingent or otherwise, was not a debt "to be extended" nor did its claim fall in the class to be extended; therefore, Section 307 of Chapter XI does not apply. These last mentioned cases are cited in support of the contention of appellant that the penalties in question are allowable as a part of the claim herein as contingent debts of the debtor. These cases, it seems, cover the subject matter of the broad construction to be given certain provisions under the old reorganization section of 77-b. It should be noted that a reorganization is a proceeding now covered by Chapter X of the Bankruptcy Act, as distinguished from the proceeding here, which is a Chapter XI proceeding, and the proceeding in this case is basically a composition.

It is a composition in that it offers to pay general unsecured creditors immediately fifty cents on the dollar in full satisfaction of their claims, and a plan of arrangement or an extension of payment insofar as it permits general unsecured creditors, who so indicate, *in writing,* to be paid the full amount of their claims upon a time payment plan.

Frequently attorneys, and a few courts, who are not too familiar with the provisions of the Bankruptcy Act, confuse reorganization proceedings under Chapter X with a plan of arrangement or composition under Chapter XI. The provisions of these two chapters, while they both have a bankruptcy complexion, vary widely in their provisions and the method of operation, and it is never safe to follow a decision involving a question in a reorganization proceeding in support of a similar question involved in a Chapter XI proceeding without first carefully analyzing the provisions of each of the chapters.

Tax Penalties Not Properly Allowable Under Section 307, Chapter XI.

Even if it were possible for a tax penalty to be approved as a claim under the provisions of Section 307 of Chapter XI, still the appellant here has not qualified. The appellant here did not indicate, in writing, its desire to accept the extension of time for payment of its penalties. Therefore, if the penalties were allowed, under any stretch of the imagination, they would fall in the classification of creditors coming under the composition as distinguished from the time payment plan. Of course, if either the plan of arrangement or composition was approved, it is obvious, under the provisions of the Act, taxes would have to be

paid in full, but this could never include a claim for penalties unless they were liens against the property.

Appellant here, in one breath, says that its claim falls in a class of creditors whose debts are to be extended (Section 307, Chapter XI) and in the next breath says that this estate or the receiver or somebody should pay it a penalty of $350.30 because the receiver did not pay its full claim, including interest and penalties by March 7, 1948. If that isn't an effort to twist the law, it will answer the purpose until a real twister comes along.

To Accept Appellant's Interpretation of Section 307 of Chapter XI Would Be Inconsistent With the Context of All the Provisions of Chapter XI and of the Bankruptcy Act as Well.

Forgetting for the moment that Section 307 is "applicable exclusively to the debts to be extended" the first part of the section begins by saying: "unless inconsistent with the context and for the purposes of an arrangement. . . ."

We submit that to include a tax penalty within the meaning of the words "debts" or "claims" would be inconsistent with the provisions of Sections 302-306, subdivision 1; Section 337, subdivision 2; Sections 352, 356, 361, 367, subdivision 2, and 371, all of which distinguish between prior and general unsecured debts and claims, and the manner and priority of payment thereof.

The words "unless inconsistent with the context" have a substantial bearing upon the question here involved. Congress definitely had in mind to make the provisions of Section 57-j a part of Chapter XI by the provisions of Section 302 of Chapter XI unless provided otherwise in said chapter. Had Congress intended that a tax penalty

should have been included under the provisions of Section 307, it would have been a simple matter for it to have so stated, and that it would have done so is indicated by its reference to Section 63 of the Bankruptcy Act in said section.

See

Collier on Bankruptcy, 14th Ed., Vol. 8, p. 67, par. 2.21.

Duty of Receivers.

As we have said before, there is no duty imposed upon a receiver in a bankruptcy proceeding either under Chapter XI or otherwise, to file tax returns covering tax periods prior to the filing of the bankruptcy petition. Receivers are custodians. (Bankruptcy Act, Sec. 2, Subd. 3.) Receivers may operate the property of a bankrupt or debtor if authorized so to do by the Bankruptcy Court. Ordinarily they do not pay dividends to creditors. This is the duty of a trustee in bankruptcy. (Bankruptcy Act, Sec. 47, Subd. 11.) The only time of which we are aware that a receiver would be called upon to pay dividends and/or claims of a debtor would be after the confirmation of a plan of arrangement or composition where there was no trustee and the receiver remained in possession. When a Chapter XI proceeding is filed and a receiver is appointed to take charge of the assets, he is without authority to pay any claims due at the time of the filing of the proceeding until a plan of arrangement is confirmed or an order of adjudication entered for failure of confirmation of the plan. If an order of adjudication is entered, a trustee is ultimately appointed and it then becomes the duty of the trustee to pay dividends to creditors. We mention this for

the reason that the appellant is attempting to assert a penalty for the failure of the receiver to pay tax which was due prior to the filing of the petition under Chapter XI, and to pay the same on a date prior to the confirmation of the plan of arrangement herein. If a receiver attempted to follow such a practice, he would go beyond the authority vested in him under the provisions of the Bankruptcy Act, and would get himself into deep water.

The writer of this brief recalls a case of an oil refinery which was in bankruptcy and which, for a time, was operated by a receiver. The exact name of the case has escaped me but I believe it was the case of *Edington Oil & Refining Co.* In this case, the entire assets of the bankrupt were ultimately sold for an amount insufficient to satisfy tax claims of the State and Federal Government in full, and there was extended litigation between the State and Federal Government over the question of liens and rights of priority. Suppose that the receiver in this case had attempted to pay some of the tax claims to have avoided claims for penalties. It is not difficult to see where he would have ultimately found himself. We mention this to emphasize the folly of the contention of the State that the receiver should have paid the tax claims to have avoided the penalties in question. There was no definite way of the receiver or referee knowing what the total amount of the tax claims filed in this proceeding would ultimately be or what the situation would be with respect to the amount of other claims having priority under the provisions of Section 64-a of the Bankruptcy Act.

Act of June 18, 1934.

The Act of June 18, 1934, cited as authority for the proposition that where a receiver operates a business he is liable for the same State taxes as though said business was being operated by the individual, obviously refers to the incurring of taxes by the receiver subsequent to his appointment and beginning with his operations, and not to the payment of taxes which were incurred by the debtor prior to the filing of the petition. In speaking of the legislative history of this Act and its purpose, the Supreme Court in the case of *Palmer v. Webster & Atlas Nat. Bank of Boston,* 312 U. S. 156, 61 S. Ct. 542 at page 545, said:

> "The legislative history of the Act discloses its purpose. The committee reports accompanying the bill which became the Act of 1934 state: 'The purpose of this bill is to subject businesses conducted under receivership in Federal Court to State and local taxation the same as if such businesses were being conducted by private individuals or corporations.' The reports advert to the fact that federal courts had held a federal receiver operating a business exempt from state sales taxes. They conclude: 'No good reason is pereceived why a receiver should be permitted to operate under such an advantage as against his competitors not in receivership, and the States and local governments be deprived of this revenue.'
>
> "What Congress intended was that a business in receivership, or conducted under court order, should be subject to the same tax liability as the owner would have been if in possession and operating the enterprise."

We do not question the fact that this Act makes it encumbent upon a receiver or trustee, who operates the property of a bankrupt or debtor to pay State taxes incurred under and by virtue of his operation, but this clearly is distinguished from the payment of taxes which were incurred by the debtor or bankrupt prior to the filing of the bankruptcy proceeding.

We, therefore, respectfully submit that the disallowance of the penalties in question as a claim in this proceeding was justified under the facts and law of the case, and that the decision of the District Court should be affirmed.

Respectfully submitted,

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